DOW THEORY LETTERS INC.

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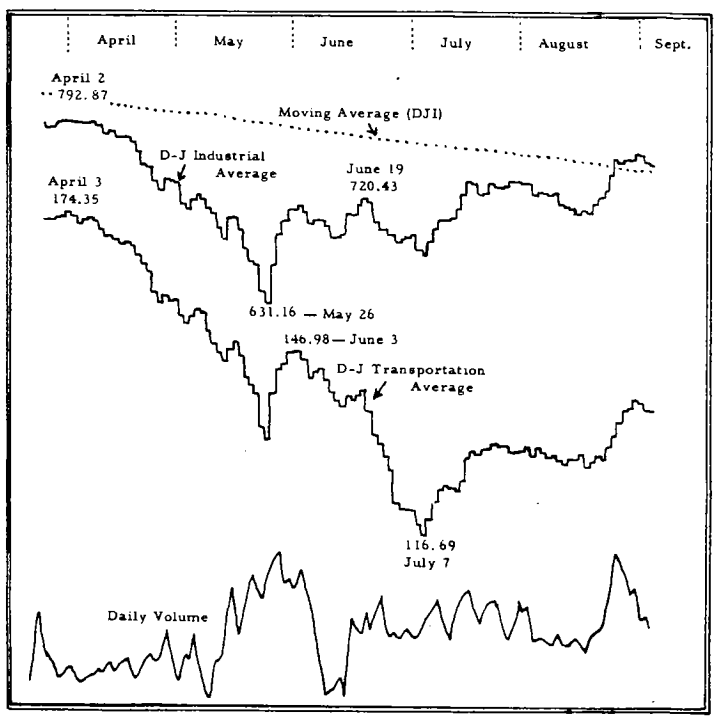
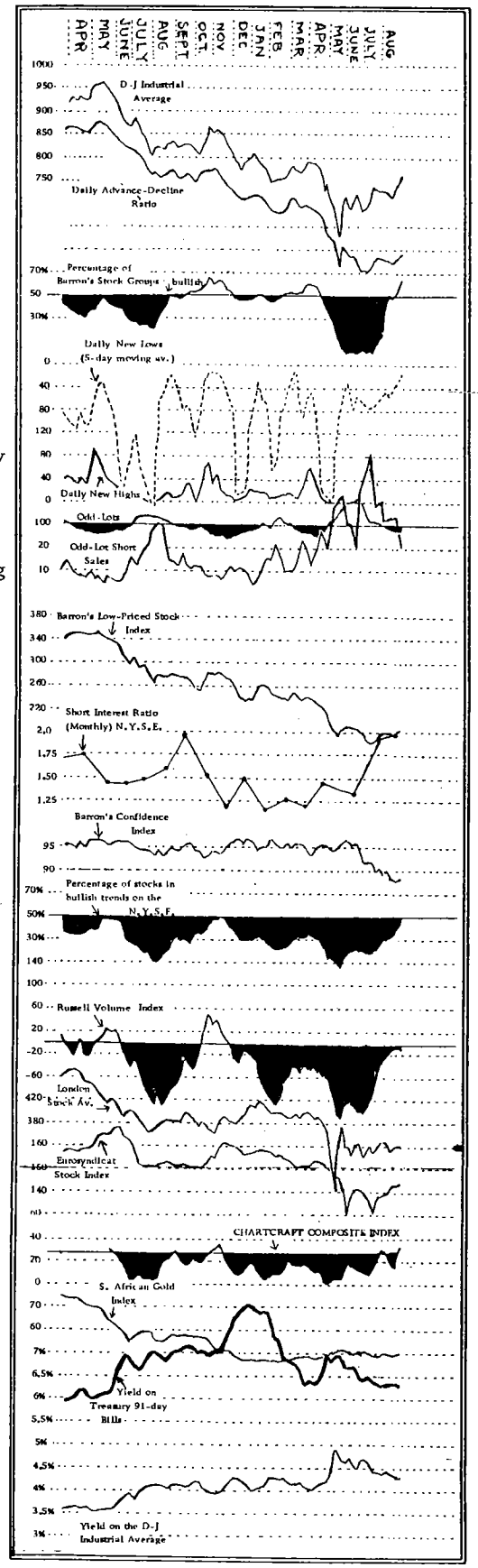
THE MARKET: The word seems to be, "Get in the new bull market before its too late." Here we are, some three-and-one-half months after the May lows and volume has already been of super-bull market proportions with a sprinkling of 15, 17 and 18 million share days a week ago. This is hardly the sort of participation one would expect as the Averages climb off a major bear market bottom. Study the charts of 1949 and 1950, and you will note that volume at that time averaged around a million shares a day. Apathy and disbelief were the keynotes during those early bull market days. The very opposite is true today.

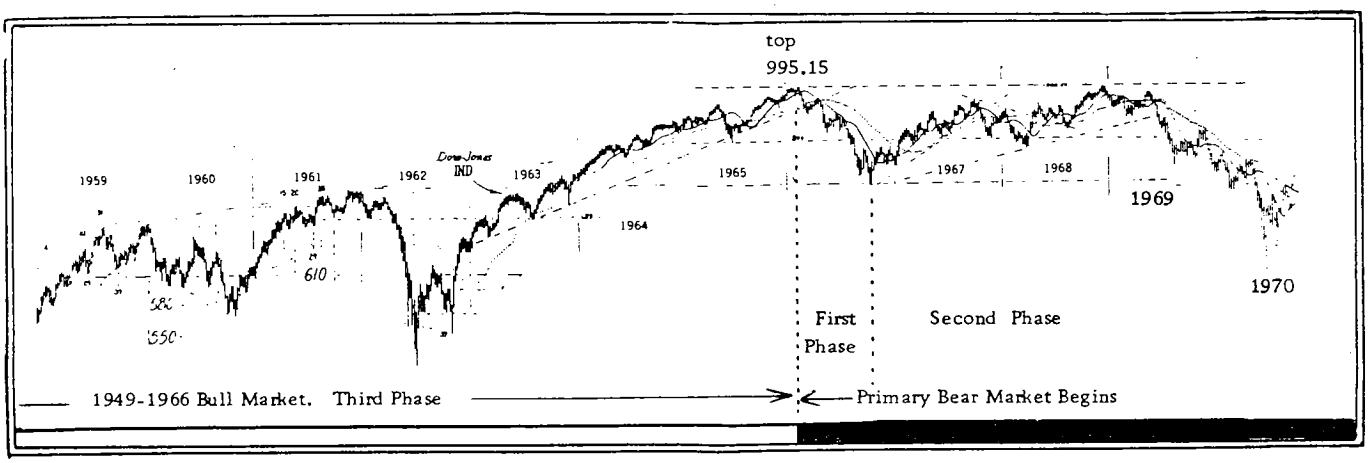
Most recently, the market has been in what I would term a "buying panic". The advance-decline ratio was up every day between August 17 and August 31, and "sold out" stocks have jumped in a manner reminiscent of 1967 and 1968. The Dow Industrial Average has pushed slightly over its own 200-day moving average (see chart 1). The losses on the short side (see last Letter) have been severe in many cases, and traders, sensing the short squeeze, have piled in and adding their weight to the market's impetus.

Bear market rallies, as both Rhea and Hamilton often noted, have a habit of looking incredibly like the "real thing". In fact, some of the most violent upside action in market history has occurred during bear rallies. Bear market rallies can end with a massive amount of churning, a persistent non-confirmation in the Averages or often both. So far, the only flaw in the technical picture during this bear rally has been the non-confirmation on the part of the Transportation Average. The 146.98 Transport rally peak of June 3 still stands, and all the upside action has not enabled the Transports to better that June high.

On the fundamental front, the Administration continues to broadcast every scrap of optimistic evidence in an almost hysterical attempt to prove to the nation that as elections near, the powers that be in Washington have everything well in hand.




APR MAY JUNE JULY AUG SEPT OCT NOV DEC JAN FEB MAR APR MAY JUNE JULY AUG
D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lots
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the N.Y.S.E.
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
CHARTCRAFT COMPOSITE INDEX
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average



Following the time-honored policy which states that there is nothing bad in the business world that an injection of inflation and fiat dollars can't cure, the Government is doing everything it can to get the "show windows" ready for fall. One thing our leaders can't do, however, is hide all the symptoms of manipulation. In the last issue I showed that the D-J 40-Bond Average had sunk to its lowest level in history (since 1915). This week's symptom is the European gold price rising over $36 per ounce, while gold shares headed towards their highest levels in a year. Meanwhile, Europeans ponder their prospective new gold-backed currency, a vehicle which will allow them to cut loose from the dollar. Lastly the British pound, amid rumors of a possible new devaluation, sank (last week) to its lowest level in eleven months.

I include a weekly chart of the Dow Industrials (courtesy of Quote Digest, 403 N. Main, Wichita, Kansas 67202), and here we see the third or speculative phase of the 1949 to 1966 bull market and the bear market from 1966 to date. On studying this chart one immediately notices that the first phase and the second phase (so far) of the bear market have failed to wipe out even the last rampantly-speculative upward sweep of the preceding bull market, a sweep which encompassed the period 1962 to 1966.

This is most extraordinary, and it is a testiment to the "built-in" optimism which has been characteristic of the whole American scene since the early 1960's. The fact is that here, almost five years after the inception of the primary bear market, the Dow has failed to wipe out the excesses of its last upward fling. I know of no other instance where a bear market, after an extended period of time, had failed to erase the excesses of the previous bull market's third phase.

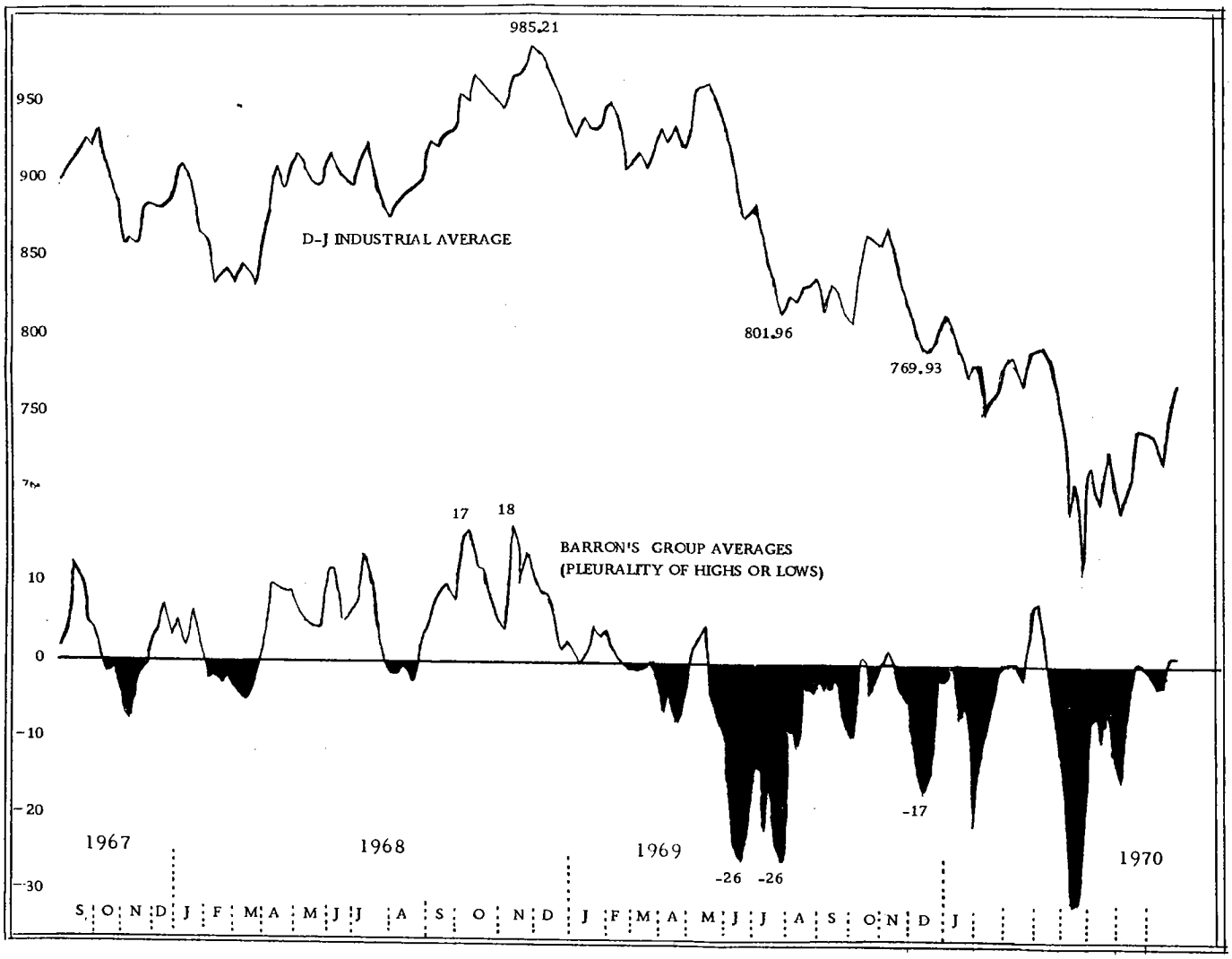
This leads me to the conclusion that this primary bear market still has a long way to go. As a rule, based on past history, the longer the primary trend is held back, the longer the speculative excesses are "held intact" and uncorrected, the worse the next sweep of the bear market. I do not know whether the primary bear forces are going to reassert themselves this month, next month or after the November elections, but assert themselves they will.

All during the 1967 and 1968 rise I insisted that we were seeing a great speculative correction within a continuing primary bear market. I stated that the result of that counter-primary trend action would be a collapse of crushing intensity. The years 1969 and early 1970 provided the answer. Now again I am saying that what we are seeing is nothing more than a speculative correction within a continuing bear market. The greater the up-move, the greater the speculative fever now, the worse will be the final act of the second phase and the more shattering will be the third and final phase of this developing tragedy on Wall Street.

I have been receiving calls ever since late-1968 from subscribers asking what they should do with stocks they hold. "Sell them", was my answer. "This is a major bear market, and before it's over stockholders are going to get hurt badly". I believe the majority of my subscribers took my advice, and in so doing they avoided the severest market collapse since 1937. I never advocated short selling during that period, and I repeatedly stated that 80% of the short sellers I know have ended up with losses.

In the last few weeks I have received calls from subscribers who are being squeezed on the short side. So I'll repeat again that I do not advocate shorts. Shorting is a professional game, and you are probably going to end with losses for all your efforts.

The subscribers who have the patience to stay liquid are going to be the one who come out ahead in this bear market. I have suggested a 10% to 15% position in gold shares as a hedge against monetary chaos, and I still like the gold position. In the meantime, the bear will tell its story in its own way. Our job is known as "the waiting game".



GROUPS: Some of the simplest indicators work best. One indicator which I watch (it was last discussed in Letter 451) is the plurality of new group highs and lows. Each week in Barron's Market Laboratory page, 35 groups are listed, showing price range for the year and the weekly price range. If a given group makes a high for the year, an "H" is placed on the tabulation; if a low is recorded an "L" is shown. The accompanying plurality chart works like this: If during a given week there were five highs and one low, a plus four is entered on the chart. It's as simple as that.

The rationale is also simple. During a drastic bear move an increasing number of groups will record new lows for the year while new highs will shrink or disappear. The opposite is true during a sustained bull move. The chart, which covers the period from mid-1967 to date, shows that a peak of plus 18 was recorded during November, 1968. From then on the indicator declined, hitting lows of minus 26 during June and July, 1969. A rally during early 1970 took the indicator to plus eight in April, 1970. The drastic decline to the May, 1970 low (Dow 631.16) produced a minus 31, the worst figure of the bear market.

On the week ending August 24, Grocery Chains and Oils touched new 1970 highs while Motion Pictures touched a new low, thereby producing a plus 1 on the chart. Last week (week ending Aug. 28) one group, Oils, touched a new high for the year, thereby registering another plus one on the chart.

PERSPECTIVE: It has been four-and-one-half years since the Dow recorded its all-time high of 995.15. Since 1942, there has never been more than a three-year span between a Dow peak and a new higher peak on the Dow. The three-year instance came following the 1946 bull market top. The Dow touched its low in 1949 (at 161.60), and by 1950 the Dow had pushed to a new peak above the 1946 high.

The current four-and-one-half year span was last surpassed during the 1930's, when following the 1937 high of 194 it required nine years (1946) until the next new (higher) peak on the Dow was recorded.

 As documented in the last Letter, during the course of the four-and-one-half year bear market, 43% of all the Dow gains from 1949 to 1966 were wiped out. On the face of it, this was a severe loss. But compared to other major bear markets the loss of 43% of all the gains of the preceding bull market was rather minimal. I think that before this bear market is over, the losses are going to stretch considerably beyond 43%.

Aside from historical (comparison) considerations, I say this because I feel that little or nothing has been solved during the years since the 1966 peak. Bond and stock yields are still as much out of kilter as ever. The liquidity problem is still as bad as ever. Inflation has not been stopped. Speculation is still rampant on Wall Street. The Federal budget deficits are still bad with 1971 calculated to produce a whopping new deficit.

In fact, the whole monetary problem has never been confronted, it has merely been swept under the rug time and time again. In his most recent report, Humphrey Neill (Letters of Contrary Opinion) quotes famous monetary economist Philip Cortney on this subject, and I would like to repeat Neill's abreviated quote: "The dollar crises of recent years have been due to a lack of gold liquidity and the balance-of-payments' deficits caused by inflation and by keeping gold at $35 an ounce.....I am convinced that there is no solution to the present crisis of the dollar and the U.S. finances which would not entail a substantial boost in the price of gold. The damage done by credit excesses cannot be repaired by further expansion of credit or bad money."

I happen to agree with Mr. Cortney. What I think has occurred is a massive, manipulative power game, in which the U.S. has held the whip-hand. Because the world has depended so throughly on the U.S. ability to produce, the powerful U.S. defense system, the gold exchange system in which U.S. dollars were held in foreign central banks in the basis that they were "as good as gold", because of all these and other factors the U.S. has gotten away with a kind of "fiscal murder". Nobody has had the power or the will to stop the U.S. because the stakes were so incredibly high.

But as Bernard Baruch put it, in the end "two plus two always equals four". And all the manipulations and power plays cannot erase the fact that inflation is still U.S. policy, that dollars continue to pile up in foreign central banks, and that the time of reckoning is drawing ever closer.

I have received many letters from subscribers who are sincerely concerned about this nation, and the common theme is, "What do you think should be done?" I only wish I had the answer. I feel that to continue along the present course will ultimately produce such a breakdown that this system, as we know it, will cease to be. The question then is, what changes can be made? To my mind, the only worthwhile changes must be fundamental ones. The heartbreaking problem is that the system is now so out-of-whack that I cannot conceive of any fundamental changes which will not also be painful ones.

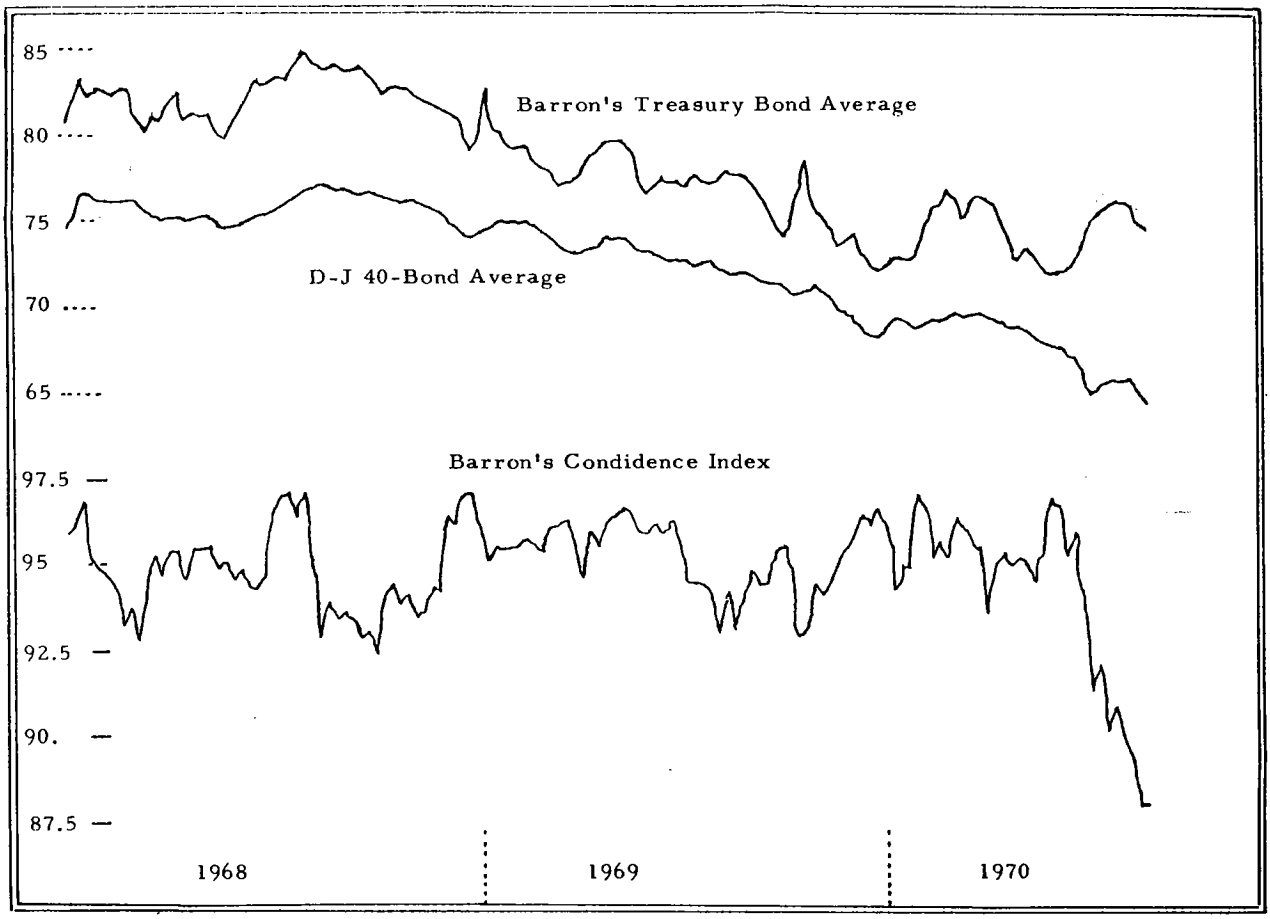
For instance, the whole nation for years has been operating on the basis of steady growth which depends in large part on ever-rising demand and ever-increasing debt to finance that growth. Behind this type of thinking there must, of necessity, be a bed-rock of perpetual confidence. This confidence has very definitely been present over the past decade, and it is this confidence which has allowed the U.S. to mount its frightful debt structure. This same confidence has allowed corporations to become unbelievably illiquid. Now an individual or a corporation, if they are liquid and flushed with cash, can sustain a big financial shock and emerge in good health. But put that individual or corporation on "a shoestring" and a financial shock will drive them into bankruptcy.

Thus, any real attempt to stop inflation on a permanent basis would entail tight control over the money supply, perhaps a return to the gold standard (wherein dollars can be turned in by citizens for gold and where gold itself would be the only true reserve), and the general acceptance by government and the citizens of the laws of supply and demand.

Such changes would without any doubt (even if the price of gold were tripled along with other measures) bring about dislocations and shock. Therefore, if I had to supply "an answer" to the question, "What would you do?" I would say that I would switch to orthodox fundamentals in the economy, prepare for the shocks, no matter how massive, and above all (if I were a politician) I would tell the people the truth.

There have been numerous periods in American History in which American citizens have undergone huge sacrifices when those sacrifices were necessary. In my opinion, if a strong and honest Administration presented the true facts to the currently inflation-wracked American citizenry there would be a reasonable chance that sweeping fiscal and monetary reforms would pass, no matter what the hardship.

At any rate, this would be my approach. I might add that it in no way resembles the approach of any Administration of the past 40 years and therefore I will repeat the adage I use when describing the current system: "Politicians never move until they are pushed. They are never pushed until events and reality explode like a bomb over the heads of the people." Sad, but I think true.



BONDS: In the last Letter I included historical and current charts on the 40-Bond Average, and many readers may have been surprised to learn that the 40-Bond Average was pennies above its all-time low, a low that encompasses the period of 1915 to the present.

In the August 26 Wall Street Journal my friend Eliot Janeway was quoted to the effect that business is entering a high-level period of "profitless prosperity", with such problems facing industry as huge payouts for anti-pollution campaigns, high labor factors and enormous investments in overhead which won't produce profits. With it all, industry is going to have to face a bond market jammed with new issues, new issues from every segment of the economy from the cities to the states, from public corporations to municipalities.

The accompanying chart shows the bond picture from a different angle. Here we see Barron's Treasury Bond Average (published weekly in Barron's) hitting its lowest point on record the week of May 25 (low point 70.92). A rally carried into August with a peak of 76.29 being recorded. The latest reading shows the Government Index, following the rather weak recent rally, back in the 74 area again.

The 40-Bond Average, as seen on the chart, is currently within a fraction of its lowest level on record. At these fantastically depressed levels, the 40-Bond Average offers a yield of 9.11%, which incredibly, is more than double the current 4.31% yield on the D-J Industrial Average.

This brings up the interesting question: Which is justified, the 9.20% yield on the 40-Bonds or the 4.31% yield on the Dow Industrials? In my opinion, the bond yields are the ones which are more nearly justified. They correctly reflect the towering debt structure of 1970 with its threat of even greater towers to come. On the other hand, I feel that the Dow Industrials, at their current historically low yield, are reflecting investors' hopes that the future will see increased earnings on the Dow stocks and increased dividends. In other words, investors hope that the Dow Industrials will continue to act as an inflation hedge.

 This position may seem absurdly naive, but the logic of it is clear enough. Clear enough, but I am afraid that few investors are aware of it. For if investors simply wanted income they would be doing nothing but buying bonds. Bonds at their current levels offer the greatest return in 100 years. But bonds have, over the last quarter century, offered no protection against inflation. Common stocks have provided inflation protection (where stocks have been properly selected), and it is obvious that the massive yield advantage now available in bonds over stocks still attests to the investors' faith in the ultimate income and inflation-protection advantages of common stocks over bonds.

Personally, I don't believe that the public's faith in stocks over bonds has begun to face reality. The average investor does not realize what he is doing when he buys a stock yielding 4% instead of a bond yielding 8.5%. What he is doing is betting that over the foreseeable future, the earning and growth power of the stock will more than make up for the fact that the bond already yields twice what the stock yields. In view of the financial problems which now beset the nation, I believe such thinking is fallacious.

This type of thinking is the more incredible when we study the path of Barron's Confidence Index, which is the ratio of the yields of Barron's 10 Highest Grade Bonds to the yield on the broad D-J 40 Bond Average. Here's what has happened. During the week ending July 5, the high-grade bonds yielded 8.36%. During the same week the 40-Bond Average yields 9.16. Since then high-grade bonds have rallied, bringing their yield down to last week's 8.11. During the same period, the 40-Bonds actually declined, pushing their yields up to last week's 9.20. The movement of safety-conscious investors out of the 40-Bonds (raising their yield) into the high-grade bonds (lowering their yield) has caused Barron's Confidence Index to plunge almost 10 points.

Now it is very rare for investors in bonds to become safety-conscious without that attitude rubbing off within a few months on investors in stocks. In fact, the relationship is so persistent that it is said that broad movements in the Confidence Index are followed within a few months by corresponding movements in the stock market.

The plunge in the Confidence Index over the past few months has taken that Index to its lowest level since 1963. I see it as an omen for the stock market during the fall of 1970. Personally, I do not like to dwell too exactly on the time lag between the Confidence Index and the stock market. It is sufficient to realize that the current rally is occurring while sophisticated bond buyers are moving towards caution and safety (even while dealing with securities which are far "safer" than common stocks).

SAN DIEGO: Every year or so I talk about San Diego. I do not consider this a plug for my part of the world, I consider it (pardon the expression) a service to subscribers. I spent the whole first part of my life in New York City, and I know the East well. After ten years in San Diego (the last three in La Jolla, which is a suburb of San Diego) I feel that I know this part of the country pretty well too.

I won't say I liked New York (although it was a pleasant place to live prior to World War II), because I didn't. I found living conditions in Gotham to be nearly impossible, and in 1960 I headed out to the Coast to look for a new place to live. After riding up and down California I picked San Diego both by choice and process of elimination (San Francisco was eliminated because of the weather, Santa Barbara was too provincial, L.A. was too sprawling and smoggy). That left the area which I think is one of the finest in the nation, San Diego.

San Diego is little known to Easterners, better known in the mid-West. It is a town of 700,000, and 14th largest in the nation (I believe it has just edged out San Francisco in population). San Diego, to my mind, represents an ideal place to live. It is big enough to provide culture, it is not big enough to be congested, it still has civic pride, it possesses certain attributes about which it can be proud.

The San Diego area has miles of beautiful coastline extending from Torrey Pines Park in the north down to the Mexican border (the border is about 20 miles south of downtown S.D.). To the east is the desert and the Anzo-Borrego State Park, which is as magnificent a stretch of real desert as I have ever seen. Twenty-five miles northeast of San Diego are the mountains, with endless stretches of empty, spacious beauty and resort and camping spots. Tiny rustic villages punctuate the mountain area.

Of interest to easterners is the cost of living in S.D., which I think is really at bargain levels. Restaurants here run $3 to $5 per meal, motels run $8 per room up, housing can be obtained at relatively low rates, but best of all there are endless recreational facilities here which cost nothing at all. It's the lure of the outdoors literally 350 out of every 365 days which is the giant attraction. Temperatures in S.D. run roughly from 45 to 55 in the winter and from 60 to 70 during the summer. Rain is almost non-existent, coming for a few months (when it does come) during the winter. This means that sun and clean air are almost always available, whether that means (to you) a game of golf, gardening, puttering around shops in Mexico, swimming, climbing mountains or meditating on the beach. I'm running out of room, but I guess subscribers should get the idea. I like San Diego. I've never seen any place like it.